

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

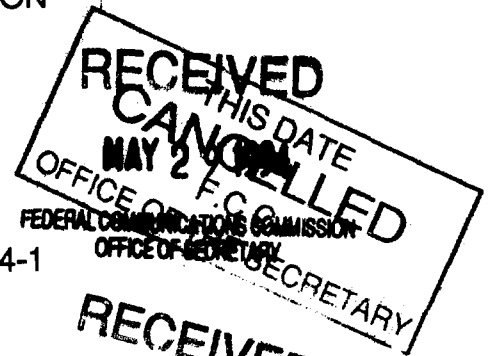
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In the Matter of)

Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1

TO: THE COMMISSION



GTE's REPLY COMMENTS

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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SUMMARY

The Commission should adopt a new LEC price cap plan including an adaptable framework. That framework should adjust the degree of regulation to match the degree of competition in each access market and streamline regulation only where competition is shown to exist. Such a framework would establish reasonable expectations upon which all firms, and their customers, could base their market decisions. The Commission should structure this framework to accommodate a reasonable definition of relevant markets. The overall relevant market should be the interstate access market broken down into limited geographic areas, and within those geographic areas further segregated into broad groupings of substitutable access services.

The adaptive framework proposed by GTE will provide effective protection for consumers against anticompetitive pricing behavior by LECs. It will afford this protection at the minimum possible cost, in terms of distortion from the efficient outcome a competitive market would produce. Maintaining current pricing constraints or introducing new ones, as some parties suggest, is unnecessary and inefficient. These proposals are designed only to protect the competitors who advance them, rather than consumers. GTE contends that improvements in the new service rules must be made to allow added flexibility while at the same time achieving Commission goals of protecting ratepayers. The record in this docket as well as the AT&T price cap proceeding is clear -- relaxed regulation of new service introductions provides tangible results to access customers and telecommunications consumers as a whole.

In instituting a price cap plan, the Commission sought to provide the same incentives for LECs to increase efficiency as competitive firms. The plan has ensured that rates would fall in real terms, while providing LECs an opportunity to increase earnings. Those parties seeking cost of capital adjustments based on LEC earnings levels would regress to rate of return regulation to control profit levels. They argue that exchange carriers should be penalized for improved efficiency and denied the financial rewards offsetting the increased financial risks inherent in a price cap plan -- the fair exchange that is at the heart of the price caps concept. This is not how a competitive marketplace functions. The Commission should therefore eliminate both sharing and the low-end adjustment mechanism and allow the market to control LEC earnings. Sharing significantly dilutes efficiency incentives and tilts the balance of risk versus reward central to any incentive regulation plan.

Interest rate changes are endogenous costs reflected in the price cap formula through the GNP-PI and do not require a separate adjustment. Adjusting the price cap formula for one input factor and not adjusting for other factor prices introduces distortion into the formula. Thus, the interest rate and cost of capital analyses submitted in this proceeding are irrelevant and should be ignored by the Commission.

Long term Total Factor Productivity is the appropriate measure of overall productivity. Studies submitted by parties seeking to raise the productivity factor are flawed and should not be given serious consideration. The productivity factor should be set at 1.7 percent based on *Christensen's* Total Factor Productivity ("TFP") analysis which encompasses forty-eight states and utilizes correct assumptions regarding input and output factors. Raising the productivity factor based on flawed studies would

seriously dilute the efficiency incentives that comprise price cap regulation. Adopting a productivity factor based on TFP eliminates the need for the "50/50" common line adjustment formula.

The exogenous factor operates symmetrically in that both increases and decreases in the LECs' exogenous costs are reflected in the price cap formula. This symmetry must be recognized. The exogenous treatment of certain costs does not always benefit the LECs as is implied by those parties wanting to narrow or eliminate the treatment. In addition, as regulated utilities, LECs operate under different rules than unregulated firms and incur costs based on legislative or regulatory mandates that impact their operations in ways that do not impact unregulated firms. Until the LECs' prices are no longer constrained by regulation in this way, the LECs require exogenous treatment for costs beyond their control that are not reflected in the GNP-PI.

The impact of telecommunications on the economy is substantial. Providing the LECs with increased pricing flexibility and earnings incentives so they can compete effectively will further stimulate telecommunications and the economy. If the Commission is to attain its goal of stimulating growth and enhancing the economy of the United States, self-serving arguments made by LEC competitors, or potential competitors, for imposing more restrictive regulations on the LECs should be rejected.

GTE actively supports the building of the National Information Infrastructure. At the same time it must be recognized that the intensification of competition and technological developments have made obsolete the existing regulatory structure. The Commission should immediately develop a regulatory framework that contains clear and stable rules of competition. This framework must allow the market to provide the

same meaningful price signals to which the LECs and all other participants can respond. The logic of the price cap plan makes the risk of investment commensurate with the rewards for all participants.

There is general agreement that the goals of universal service have not been affected by the current price cap plan. The Commission can further promote its goal of universal service by establishing a new price cap plan that addresses competition and encourages efficient infrastructure development. GTE recommends that the Commission expeditiously open a proceeding to design a universal service funding mechanism that is consistent with the principles of regulatory symmetry.

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GTE's REPLY COMMENTS

GTE Service Corporation ("GTE"), on behalf of its affiliated domestic telephone operating companies, hereby offers its replies to comments submitted on the Commission's Notice of Proposed Rulemaking ("Notice" or "NPRM"), FCC 94-10, released February 16, 1994, in the proceeding captioned above.

DISCUSSION

I. LEC EARNINGS REFLECT THE INCENTIVES INHERENT IN PRICE CAP REGULATION.

A. LEC earnings are comparable to the earnings of other firms.

Price cap regulation seeks to replicate a competitive marketplace as closely as possible. In instituting a price cap plan, the Commission sought to provide the Local Exchange Carriers ("LECs" or exchange carriers") the same incentives to increase efficiency that would apply to a competitive firm -- thereby furnishing an opportunity for an increase in earnings while simultaneously ensuring that rates would fall in real terms.

This is exactly what happened during the 1991-1993 price cap period.¹ The LECs' earnings did increase during the review period, access charges were substantially reduced, and infrastructure investment has been significant.² The Commission accomplished what it set out to do in moving from rate of return regulation to price cap regulation.

Now, parties criticizing LEC earnings levels either ignore or misunderstand the very premise upon which price cap regulation was established. Ad Hoc (at 23), for example, argues: "[C]onsistent LEC high earnings levels are a clear indicator that the price cap system is not working as it was (or at least should be) intended."³ These parties refuse to recognize that:

- 1) The appropriate measure of success for a price cap plan is the benefit it generates for consumers, not the earnings of the regulated firms. The current plan has ensured that access rates would fall.
- 2) Price caps are designed to give the regulated firm the same incentive a competitive firm would have to increase earnings by improving its efficiency. Price caps ensure

¹ Ameritech (at 13-14) says: "[H]igher profit levels are what the price cap plan anticipated." BellSouth (at 39) points out: LEC profits increased under price caps but "this phenomenon is precisely what is to be expected under a price cap regime." Pacific (at 36) says: "[T]he opportunity of increasing earnings while decreasing rates was just what price cap regulation was supposed to do."

² GTE slashed its access prices by approximately \$.7 billion and invested \$10.1 billion in the infrastructure during the price cap period.

³ See, GSA at 6.

that earnings are reasonable the same way a competitive market does -- by limiting the prices LECs can charge.⁴

Since the price cap plan was intended to replicate the outcome of a competitive market, it is reasonable to evaluate the effect of the plan by comparing LEC earnings to those of other firms operating in competitive markets. This comparison shows LEC profit levels are completely in line. Indeed, LEC interstate returns during this period were lower than those of several of the parties⁵ that have questioned the level of LEC earnings.

The Return on Equity ("ROE") for the Standard & Poors ("S&P") Industrials during the 1991-1993 time period are ranked on a cumulative percentile basis in Exhibit 1. The exhibit also ranks against the S&P Industrials the actual earned ROEs for AT&T and MCI, the implied interstate ROEs for the GTE companies and the Regional Bell Operating Companies ("RBOCs"), and the current market ROE calculations of several parties commenting in this proceeding. The composite of LEC interstate ROEs is reasonably within the range of actual earned ROEs for the S&P Industrials. As shown, the average implied interstate ROEs for the LECs are lower than AT&T's 16.45 and MCI's 18.90 percent.⁶

⁴ As demonstrated in GTE's Comments (at 14-15), GTE's rate levels and earnings have effectively been constrained by market pressure, rather than by price caps.

⁵ See, AT&T at 30, MCI at 28.

⁶ The Commission has relied on market forces to constrain the earnings of MCI, and a combination of price caps and market forces to constrain AT&T's earnings. Clearly, with LEC earnings considerably lower than those of AT&T and MCI, it cannot be said that the LEC earnings are unreasonable.

It should also be noted that LEC interstate ROEs would have been significantly lower had they been able to book depreciation expense⁷ reflecting the true economic life of their depreciable assets.⁸ Even without a restatement of ROEs reflecting economic depreciation expense, these figures do not in any way suggest exchange carrier earnings have been excessive.

In summary: In instituting a price cap plan, the Commission sought to provide the same incentives for LECs to increase efficiency as competitive firms. The plan has ensured that rates would fall in real terms, while providing LECs an opportunity to increase earnings. Those parties seeking cost of capital adjustments based on LEC earnings levels would regress to rate of return regulation to control profit levels while at the same time capturing the benefits that efficiency gains under price caps have made possible: lower access prices and an improved infrastructure. In effect, they argue that exchange carriers should be penalized for improved efficiency and denied the financial rewards offsetting the increased financial risks inherent in a price cap plan -- the fair exchange which is at the heart of the price caps concept. This is not how a competitive marketplace functions.

⁷ See, Ameritech at 13; Bell Atlantic 9; Pacific at 29; US WEST at 8-9. See, also, USTA's Comments Attachment 2, Robert G. Harris, *Economic Benefits of LEC Price Cap Reform* ("Harris") at 18.

⁸ "Inadequate depreciation puts the LEC capital at risk in the out years of an investment." See, Jeffrey H. Rohlf's and Harry M. Shooshan III, "New Investment and the regulatory climate," *Telephony*, May 2, 1994, at 56.

**S&P INDUSTRIALS
RETURN ON EQUITY - 1991-1993**

(1) Cumulative Percentile	Return on Equity (2)				
	1993	1992	1991	Average 1991-1993	
0.00%	-87.64%	-69.18%	-83.09%	-64.47%	
5.00%	-23.18%	-13.46%	-18.53%	-9.34%	
10.00%	-7.27%	-3.31%	-7.80%	-2.41%	
15.00%	-2.48%	0.16%	-1.36%	-0.56%	
20.00%	2.17%	2.23%	2.51%	2.73%	
25.00%	4.88%	6.15%	4.41%	4.86%	
30.00%	7.99%	8.21%	5.84%	6.75%	
35.00%	9.57%	9.79%	7.74%	7.94%	
40.00%	10.93%	11.05%	8.99%	9.44%	
45.00%	12.37%	12.05%	10.65%	10.90%	
50.00%	13.17%	12.87%	11.69%	12.12%	
55.00%	14.04%	13.93%	12.93%	13.29%	
60.00%	14.99%	15.19%	14.29%	13.92%	
65.00%	16.61%	16.11%	15.31%	15.50%	
70.00%	17.39%	18.12%	16.75%	16.72%	
75.00%	19.07%	19.63%	18.35%	18.33%	
80.00%	20.23%	21.46%	20.43%	19.57%	
85.00%	23.10%	22.95%	22.54%	21.26%	
90.00%	26.24%	26.28%	26.46%	25.29%	
95.00%	33.61%	33.54%	36.07%	34.24%	
100.00%	79.94%	72.84%	75.35%	69.81%	
<u>Actual Earned ROE:</u>					
AT&T	24.25%	21.66%	3.44%	16.45%	Percentile 69.15%
MCI	15.95%	19.94%	20.80%	18.90%	75.80%
<u>Implied Interstate ROE:</u>					
GTE				12.85%	54.26%
Ameritech				17.73%	72.61%
Bell Atlantic				16.34%	68.35%
BellSouth				15.79%	66.22%
NYNEX				13.22%	54.79%
Pacific Telesis				15.55%	65.69%
Southwestern Bell				14.30%	61.44%
US WEST				15.22%	63.83%
Composite LEC				15.10%	63.56%
<u>Current Market ROE:</u>					
AT&T Calculation				11.91%	47.34%
MCI Calculation				11.00%	45.48%
GTE Calculation - Midpoint				14.01%	60.37%
Billingsley Calculation - Midpoint				14.41%	61.70%

(1) Returns greater or equal to 100% or less or equal to negative 100% or more were eliminated as outliers.

(2) Rankings for each year are evaluated independently. Average ROEs for 1991-1993 are ranked based on average earnings for individual firms during the time period.

IMPLIED INTERSTATE ROE
GTE AND BELL TELEPHONE OPERATING COMPANIES
1991-1993

	<u>Average Debt</u>			<u>Average Preferred Stock</u>		
	Percent of Capital (A)	Cost Rate (B)	Weighted Cost Rate (C=A*B)	Percent of Capital (D)	Cost Rate (E)	Weighted Cost Rate (F=D*E)
GTE	40.995%	8.696%	3.565%	1.219%	6.33%	0.077%
Ameritech	41.642%	7.640%	3.181%	0.000%	0.00%	0.000%
Bell Atlantic	39.831%	8.132%	3.239%	0.000%	0.00%	0.000%
BellSouth	38.592%	8.689%	3.353%	0.000%	0.00%	0.000%
NYNEX	41.091%	8.938%	3.673%	0.000%	0.00%	0.000%
Pacific Telesis	43.130%	8.675%	3.742%	0.000%	0.00%	0.000%
SWBT	41.544%	8.244%	3.425%	0.000%	0.00%	0.000%
US WEST	39.606%	8.398%	3.326%	0.000%	0.00%	0.000%
Composite	40.681%	8.462%	3.442%	0.197%	6.33%	0.012%

	<u>Average Common Equity</u>			
	Percent of Capital (G=1-A-D)	Implied Interstate ROE (H=I/G)	Weighted Cost Rate (I=J-C-F)	Average Interstate ROR (J)
GTE	57.586%	12.854%	7.428%	11.070%
Ameritech	58.358%	17.734%	10.349%	13.530%
Bell Atlantic	60.169%	16.344%	9.834%	13.073%
BellSouth	61.408%	15.786%	9.694%	13.047%
NYNEX	58.909%	13.219%	7.787%	11.460%
Pacific Telesis	56.870%	15.553%	8.845%	12.587%
SWBT	58.456%	14.305%	8.362%	11.787%
US WEST	60.394%	15.223%	9.194%	12.520%
Composite	59.122%	15.104%	8.930%	12.384%

Source: Columns A, B, D, E, G from Form M
Column J from Form 492

Exhibit 1

B. No adjustment is required to reflect changes in the cost of capital.

GTE agrees with those parties maintaining that interest expense (as well as other capital costs) is an ordinary cost of doing business, is endogenous, and is accounted for in the price cap formula through the GNP-PI.⁹ GTE opposes those parties seeking to turn price caps into a modified rate of return mechanism.¹⁰

The entire economy is affected by interest rate fluctuation. Anyone purchasing a home or holding an existing mortgage is well aware of the speed with which interest rates can vary -- either up or down -- over short periods of time. Although interest rates have declined from levels prior to the establishment of the initial price cap plan, they have increased over 100 basis points since the 4th quarter of 1993 and, as shown in Exhibit 2, additional increases are projected for the remainder of 1994.

⁹ See, Ameritech at 13; BellSouth at 38; Pacific at 35-42; US WEST at 16-17; SWBT at 40; Lincoln at 10-11; Rochester at 18-20, CSE at 4-5.

¹⁰ See, AT&T at 32; MCI at 18 and 28; WilTel at 25; ICA at 13; OCCO at 8; ARINC at 3; GSA at 4; CCTA at 6.

INTEREST RATE TRENDS

	Average AA Public Utility Bonds	Average US Long-term Government Bonds	Average US Intermediate Government Bonds
Jan-90	9.39%	8.65%	8.42%
Feb-90	9.57%	8.76%	8.55%
Mar-90	9.60%	8.89%	8.71%
Apr-90	9.81%	9.24%	9.07%
May-90	9.83%	8.83%	8.64%
Jun-90	9.60%	8.64%	8.43%
Jul-90	9.61%	8.60%	8.19%
Aug-90	9.78%	9.20%	8.59%
Sep-90	9.87%	9.14%	8.51%
Oct-90	9.77%	8.98%	8.26%
Nov-90	9.59%	8.58%	7.95%
Dec-90	9.42%	8.44%	7.70%
Jan-91	9.39%	8.37%	7.72%
Feb-91	9.16%	8.41%	7.74%
Mar-91	9.23%	8.44%	7.83%
Apr-91	9.14%	8.37%	7.72%
May-91	9.16%	8.45%	7.73%
Jun-91	9.28%	8.60%	7.93%
Jul-91	9.26%	8.50%	7.78%
Aug-91	9.06%	8.18%	7.32%
Sep-91	8.95%	7.90%	6.93%
Oct-91	8.92%	7.91%	6.73%
Nov-91	8.87%	7.89%	6.53%
Dec-91	8.71%	7.30%	5.97%
Jan-92	8.63%	7.76%	6.83%
Feb-92	8.76%	7.77%	6.90%
Mar-92	8.82%	7.97%	7.20%
Apr-92	8.76%	8.03%	7.11%
May-92	8.69%	7.81%	6.74%
Jun-92	8.63%	7.65%	6.47%
Jul-92	8.45%	7.26%	6.04%
Aug-92	8.30%	7.25%	5.81%
Sep-92	8.28%	7.10%	5.47%
Oct-92	8.42%	7.41%	6.01%
Nov-92	8.51%	7.48%	6.34%
Dec-92	8.32%	7.26%	6.11%
Jan-93	8.14%	7.25%	5.88%
Feb-93	7.92%	6.98%	5.47%
Mar-93	7.76%	7.02%	5.49%
Apr-93	7.64%	7.01%	5.40%
May-93	7.64%	7.01%	5.51%
Jun-93	7.54%	6.68%	5.17%
Jul-93	7.38%	6.56%	5.26%
Aug-93	7.07%	6.23%	4.86%
Sep-93	6.89%	6.27%	4.83%
Oct-93	6.89%	6.23%	4.88%
Nov-93	7.17%	6.51%	5.19%
Dec-93	7.18%	6.54%	5.22%
Jan-94	7.18%	6.37%	5.15%
Feb-94	7.34%	6.82%	5.75%
Mar-94	7.74%	7.25%	6.38%
Apr-94	8.12%	7.45%	6.70%
May-94	8.24%	7.59%	6.82%
3rd Quarter 1994	8.52%	7.45%	7.26%
4th Quarter 1994	8.54%	7.38%	7.19%

Source: Actual - Moody's Bond Record; CORR Software, Ibbotson Associates
Forecast - DRI/McGraw Hill, Review of the U.S. Economy, June 1994.

Furthermore, interest rates in any given period may rise or fall. Are these commenters suggesting what amounts to an asymmetric scheme of exogenous adjustment – considering interest rate changes in one direction but not in the other? Rising interest rates will make it more difficult for LECs to achieve "X" during the next price cap review period.¹¹ Would this be treated as exogenous? What makes sense is logical and consistent treatment of interest rate increases or decreases – as contemplated by price caps.¹²

The cost of capital is a factor price which is accounted for as endogenous, not exogenous, in the price cap formula. If the price cap formula had been designed to change based on factor prices, then all factor prices, not just the cost of capital or interest rates, would have to be reflected including such factors as labor prices and taxes. Further, any such adjustment would have to be symmetrical; it would have to reflect input price increases as well as reductions. In this instance, parties suggest that caps be adjusted because one input factor, interest rates, decreased during the price cap period.

Since interest rates for the LECs were no different than for the rest of the U.S. economy, the change in interest rates is reflected in the GNP-PI.¹³ This is substantiated

¹¹ The Commission set "X" (the productivity offset) based on historical telephone prices relative to U.S. prices where "X" equals the sum of the difference between LEC and national TFP growth plus the difference between LEC and national input growth.

¹² Some commenters appear to assume that the LECs have or could have refinanced all their long-term debt at the lower interest rates available during the period 1990 to 1993.

¹³ It is suggested that the GNP-PI understates the effect on LECs of a reduction in interest rates, because LECs are more capital-intensive than the average firm. By the same token, GNP-PI will overstate the effect of a reduction in wage rates

by the California commission. The California commission first stated costs due to economywide inflation, expected productivity improvements, and any exogenous factors are captured by the price cap mechanism. They clarified this in their recent proceeding: "The price cap index itself automatically adjusts for changes in the cost of capital as it does changes in any particular input price."¹⁴ This is clearly misunderstood by GSA (at 6) which states that changes in the cost of capital are analogous to exogenous costs. As US WEST (at 38-39) correctly points out, treating interest rate changes (or any asymmetric adjustment) as exogenous costs introduces a bias into the choice of input mix by telephone companies. Adjusting the price cap formula to reflect the change in one input cost and not for other input costs distorts decisions on the proper mix of capital, labor, and other inputs.

AT&T (at 30) argues the Commission "should direct the LECs both to implement a one-time reduction in their price caps, and to reduce the threshold triggering the sharing mechanism to reflect the change in the cost of capital since the adoption of price caps." AT&T's (at 31) calculations purport to show that the "LECs' cost of capital has averaged no higher than 9.93 percent over the period 1991-93 -- some 132 basis points lower than those carriers' current reference rate of return." Further, AT&T (*id.*) maintains that "newly authorized intrastate returns" show in 1993 the ROE declined by

on the LEC -- yet no party has suggested a positive PCI adjustment to account for this. The Commission has, for good reason, chosen not to treat shifts in specific LEC input prices as exogenous. *See also* USTA's Reply Comments, Attachment 4, *Economic Performance of the LEC Price Cap Plan: Reply Comments*, by National Economic Research Associates, Inc., ("*NERA Reply Comments*"), at 41-45.

¹⁴ The Public Utilities Commission of the State of California, Decision 94-06-011, June 8, 1994, (the "*California decision*"), at pages 58-59.

110 basis points since 1990 and LECs embedded debt declined about 140 basis points. This brings AT&T (*id.*) to the conclusion: "Based on an average RBOC debt ratio of 47.5 percent, the LECs' average weighted cost of capital during this time has declined by about 124 basis points."

AT&T's calculation of a 9.93 percent cost of capital for the LECs is badly flawed. AT&T bases its calculation on the Regional Bell Holding Companies ("RBHCs")' capital structure and embedded cost rates and an inappropriate estimate for the cost of equity. The aggregate common equity ratios and embedded cost rates for the GTE and Bell Operating Companies are much greater than those of the RBHCs.

MCI (at 28), in recommending an adjustment to the Price Cap Indexes ("PCIs"), presents its calculation of the LECs' cost of capital as 9.54 percent and (at 18) asks the Commission to require a one-time decrease in price cap indexes and not adopt an automatic adjustment for changes in interest rates.¹⁵ MCI bases its estimate of the LECs' cost of capital on an analysis performed by Matthew I. Kahal.¹⁶ As in the case of AT&T, *Kahal* inappropriately uses the capital structure of the RBHCs to calculate his rate of return estimate. While *Kahal* correctly attempts to calculate the cost of debt for the LECs, his data is suspect (particularly for Southwestern Bell) as it does not match the data provided on the LECs' ARMIS B-2 Reports.

¹⁵ MCI (at 18) seeks to capture the effects of a one-time reduction in interest rates in the price cap index going forward. MCI's interest, then, is only past costs, not prospective ones; and only downward adjustments, not upward adjustments. Theories calling for adjustments only when they favor the theorist smack of opportunism and should be rejected.

¹⁶ See, MCI's Comments Appendix A, Statement of Matthew I. Kahal, *Concerning: Cost of Capital ("Kahal")*.

AT&T's and *Kahal's* cost of equity estimates are inappropriate for several reasons:¹⁷

1. The true nature and capital market effects of increased competition in the local exchange market since 1990 was not reflected in their cost of capital estimates. These estimates assume that investors have the same view of the prospective riskiness of the LECs' business today that they had prior to 1990. This is clearly not reasonable. Competition in the local exchange market has accelerated significantly since price cap regulation was implemented. The market value of LEC stocks have declined significantly in response to the FCC's decision to require expanded interconnection.¹⁸ Bond rating agencies and investors in LEC debt and equity securities are concerned about the increasing competitiveness of the industry. Recently, Moody's Investors Service downgraded long-term debt ratings of GTE prompted by "expectation that GTE telephone operating subsidiaries face growing competitive and regulatory pressures." Moody's said that this was done even though "GTE recently took several steps to improve its competitive stance, including streamlining operations and selling nonstrategic assets'...but those 'actions are unlikely to offset increasing business risk...."¹⁹

¹⁷ See, USTA's Reply Comments, Attachment 2, *Report of Dr. Randall S. Billingsley On Behalf of the United States Telephone Association*, for additional discussion on the flaws in AT&T's and *Kahal's* methodologies. ("*Billingsley*").

¹⁸ See, *Expanded Interconnection with Local Telephone Company Facilities*, Report and Order, CC Docket No. 91-141 ("D.91-141"), 7 FCC Rcd 7369 (1992) (*subsequent citations omitted*).

¹⁹ See, *Communications Daily*, Vol. 14, No. 124, Tuesday, June 28, 1994, at 6.

2. AT&T and *Kahal* did not adjust stock prices to correct the inconsistency in the valuation of RBHCs' earnings growth rate because of cellular operations. Contrary to *Kahal's* contention,²⁰ the disparity between analysts' five year earnings projections and the expected future cash flows embedded in the LECs' stock prices is still significant and warrants an adjustment.
3. AT&T and *Kahal* made no allowance for the recovery of equity flotation costs. As with debt issuance costs, which are included in the cost of debt calculation, the LECs must be able to recover the cost of issuing equity. This can be accomplished via an adjustment in the cost of equity models. This cost is approximately five percent of a company's stock price.
4. AT&T and *Kahal* both employed an annual Discounted Cash Flow ("DCF") Model, which does not correspond with the practice of the LECs to pay dividends on a quarterly basis.
5. AT&T averaged the annual DCF Model results for the previous three years, rather than calculating a current forward-looking estimate.

Although GTE believes the cost of capital to be irrelevant in this proceeding,²¹ cost of capital data have been placed on the record by GTE to refute the data presented by AT&T and MCI. Internal GTE studies²² show the average LEC capital

²⁰ See, *Kahal* at 15: "[I]t is not reasonable to argue that little in the way of cellular profits should be expected through 1999."

²¹ This proceeding is a price cap review not a represcription proceeding. As *Billingsley* (at 1-2) states: "Traditional cost-based rate of return/rate base regulation is inconsistent with and contrary to the principles of incentive regulation."

²² See, Attachment 1.

structure to be comprised of 41.518 percent debt, .193 percent preferred stock, and 58.289 percent common equity. The embedded cost of debt and preferred stock are estimated to be 7.968 percent and 6.293 percent, respectively. The cost of equity capital for the LECs is estimated to be in the range of 13.62 percent to 14.40 percent. The overall weighted average cost of capital for the LECs is in the range of 11.259 percent to 11.714 percent. This range is higher than the 11.25 percent rate of return the Commission found reasonable in the represcription proceeding on which the current sharing ranges are based. The range is in line with the range estimated by *Billingsley*²³ and is also significantly higher than the 9.93 percent and 9.54 percent estimates provided by AT&T and MCI,²⁴ respectively.

GSA (at 6-7), although not submitting an analysis, asks the Commission to examine the yield on ten-year Treasury Bonds for August of each year and, if the yield is 150 basis points above or below the yield at the time of the last prescription, to determine a new rate of return. This proposal suffers from the same deficiencies as those discussed *supra* in association with various arguments keyed in to interest rates. CSE (at 4) very appropriately notes that: "[T]he Commission should resist the temptation to alter price caps in response to interest rate changes." And (at 5) that: "Adjusting price caps to reflect interest rate changes could undermine the LECs' incentives to make prudent decisions [on the timing of investments and term structure of debt]."

²³ See, *Billingsley* at 12. The fact that these two analyses, based on different sets of comparable firms, produce consistent results confirms the robustness of the analysis.

²⁴ See, AT&T at 31, MCI at 28.

Recent other actions by the Commission would indicate that an adjustment in the price cap formula to reflect changes in interest rate levels is unwarranted. In 1993, during its review of the AT&T price cap plan, the Commission found AT&T's earnings to be reasonable despite a change in interest rates from the implementation of AT&T's price cap plan that was greater than the change observed over the three years of the LEC plan.²⁶ In addition, the Commission in its cable reregulation proceeding²⁸ recently implemented an 11.25 percent rate of return for cable companies electing²⁷ to use cost of service standards to justify cable service rates.

In summary: Interest rate changes – which are endogenous costs reflected in the price cap formula through the GNP-PI – do not require a separate adjustment. Adjusting the price cap formula for one input factor and not adjusting for other factor prices introduces distortion into the formula. Thus, the interest rate and cost of capital analyses submitted in this proceeding are irrelevant. In any case, the LEC cost of

²⁶ In fact, the Commission did not even discuss the subject in its Report. See, *Price Cap Performance Review for AT&T*, Report, CC Docket No. 92-134, 8 FCC Rcd 6968, 6969 (1993) ("*AT&T Review*"). While AT&T has proposed that LEC price caps be adjusted to reflect a decline in interest rates, it has not suggested a similar adjustment in its own price cap plan. Clearly, all of the arguments AT&T has raised here are equally applicable: AT&T is capital intensive, it raises capital in the same markets LECs do, and its earnings over the period have been higher than those of the LECs. If AT&T's earnings have been reasonable, then LEC earnings are also reasonable.

²⁸ See, *Implementation of Sections of the Cable Television Consumer Protection Act of 1992: Rate Regulation and Adoption of A Uniform Accounting System for Provision of Regulated Cable Service*, MM Docket No. 93-215 and CS Docket No. 94-28, Report and Order and Further Notice of Proposed Rulemaking, FCC 94-39 (released March 30, 1994) at ¶207.

²⁷ Cable companies can set rates based on rate of return but price caps governs ongoing changes.

capital analyses submitted by AT&T and MCI are badly flawed and should be rejected by the Commission.

C. Sharing and the low-end adjustment mechanism should be eliminated because they have no place in price cap regulation.

Sharing and the low-end adjustment mechanism should not be adjusted because of productivity gains or changes in the cost of capital, as recommended by some commenters.²⁸ They should be eliminated because they dilute the efficiency incentives of price cap regulation and lay the burden of risk on consumers.²⁹ The sharing and low-end adjustment mechanisms distort the risks and rewards that LECs face in making investment decisions. In addition, regulatory symmetry should dictate that sharing and the low-end adjustment mechanism have no place in the LECs' price cap plan just as they have no place in AT&T's or the cable industry's price cap plans.

Perhaps most importantly, sharing is incompatible with effective regulation in a mixed environment where some markets are more competitive than others. When sharing is added to price cap regulation, it reintroduces the shortcomings of rate of return, including an artificial link across services. If a firm under sharing reduces prices in more competitive markets, or simply loses business in those markets, it may depress its earnings sufficiently to activate the low-end adjustment mechanism. This, in turn, would give the firm the ability to raise prices in less competitive markets. By eliminating sharing, the Commission can break this linkage. This will ensure that consumers in

²⁸ See, AT&T at 29-30, MCI at 27, Ad Hoc at 24-25, ICA at 14-15, ARINC at 3, OCCO at 9.

²⁹ GTE has had to raise rates in areas where it would not otherwise have chosen because of the low-end mechanism.

less competitive markets will be protected by price caps, and that these caps will be unaffected by changes in price or demand in the more competitive markets. The elimination of sharing is essential to a pure price cap plan because it is necessary to ensure that the caps in markets which have not yet reached the trigger point will not be affected by events in those markets where regulation has been streamlined.

CCIA is among the commenters very much aware of the disadvantages associated with sharing. CCIA (at 7) states that price caps are "compromised to a considerable degree by the 'sharing' mechanism" and "[t]his limitation on the extent to which LECs can benefit from efficiency improvements lessens the efficiency incentive the Commission created." As *Schankerman* notes, sharing reduces the efficiency incentives that price caps were designed to provide. These mechanisms shift the distribution of risk toward customers and away from LECs, and sharing creates the need to compute upper and lower trigger rates – which reintroduces the problem of rate base measurement, including capital depreciation policy.³⁰ *Harris* also clearly makes a good case that there "is no good economic rationale for continuing to regulate LECs' rates of return."³¹ Strategic Policy Research ("SPR") states:

³⁰ See, GTE's Comments, Attachment A, Dr. Mark Schankerman, *Competition through Regulatory Symmetry*, at 27 ("*Schankerman*").

³¹ *Harris* lists four main flaws with sharing: (1) Sharing must be symmetrical yet low-end adjustments leave customers at risk. Thus customers "share" in any underearnings by the LECs. (2) Earnings sharing plans by design limit the incentives for efficiency, innovation and good performance. (3) Sharing plans are costly and complex to administer because they require both an apparatus for price indexing and the apparatus for regulating the rate base (*i.e.*, depreciation) and rate of return. (4) The "fatal flaw" is the "death of the franchise 'monopoly'" which is at the heart of rate of return regulation. Under sharing, the regulator can no longer "realistically commit ... to any given level of earnings over the life of capital investments made today" because of the extent to which competition

Regulators have further dulled the efficiency incentives under price caps by having additional "sharing" mechanisms incorporated into their price-cap plans. Under sharing mechanisms, the firm gets to keep only a fraction of efficiency gains -- even during the initial price-cap period. The higher the sharing percentages, the less are the efficiency incentives and the less are the efficiency gains. Sharing is inherently counter-productive when the term of the price cap plan is too short, and incentives are too diluted to start with -- as is the case with all existing price cap plans.³²

SPR's analysis shows that efficiency incentives under hybrid price cap plans (*i.e.*, plans with sharing) are definitely diluted. A four year plan of "pure" price caps would produce an efficiency incentive of 35 percent compared to 18 percent for a plan with sharing. When one views the longer term, efficiency incentives at ten years compare at 71 percent under "pure" price caps to 37 percent under a sharing plan.³³

Although not subject to sharing under its price cap plan, AT&T (at 33) strongly advocates not only the retention of sharing for the LECs, but a decrease in the sharing triggers to reflect AT&T's calculation of the LECs' cost of capital. MCI (at 27), which has no cap on its earnings, proposes new trigger points based on its calculation of the LECs' cost of capital. Even if sharing were a viable component of price cap regulation - - and it most certainly is not -- these parties' calculations of the LECs' cost of capital are so badly flawed they could not serve as a sound basis for resetting the triggers.

"will govern the market for local exchange services during the life of today's investments." *See, Harris* at 19.

³² *See, SPR, Regulatory Reform for the Information Age: Providing the Vision*, January 11, 1994, at 22 ("*SPR Analysis*").

³³ *See, SPR Analysis*, Table 1 at 21 and Table 2 at 23.